Statement before the House Financial Services Committee

On Systemic Regulation, Prudential Matters, Resolution Authority, and Securitization

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Summary

The Discussion Draft of October 27 contains an extremely troubling set of proposals which, if adopted, will bring economic growth in this country to a standstill, essentially turn over the control of the financial system to the government, and seriously impair competition in all areas of finance.

Rather than ending too big to fail, the Draft makes it national policy. By designating certain companies for special prudential regulation, the Draft would signal to the markets that these companies are too big to fail, creating Fannies and Freddies in every sector of the economy where they are designated. This will impair competition by giving large companies funding and other advantages over small ones.

The idea that the designation of these companies will be kept secret is, with all due respect, absurd; securities laws alone will require them to disclose their special status; simple truthfulness will do the rest.

The government will also have extraordinary power to control the operations of those companies that are designated for special regulation. New activities, innovations, and competitive initiatives will all be subject to government approval. Companies already in a business can be told to divest it. These authorities go well beyond the powers that the Fed now has over bank holding companies. The financial system would, in effect, be managed and directed from Washington.

The Draft would separate operating or commercial companies from financial activities, even though these activities are never separated in the real world. All companies—retailers, manufacturers, and suppliers—finance their sales. In the Draft, operating companies would have to separate their financial activities into separate affiliates, and their financial affiliates will not even be able to finance the parent company or its sales without restriction. Has anyone thought how U.S. companies will compete with foreign companies when they can't finance their own sales?

No one can draw a line between finance and commerce. Yet, to protect the Realtors against competition from banks, Congress has stopped the Fed from declaring that real estate brokerage is a financial activity. If this legislation is passed, every industry will be in Washington, asking for special treatment or exemption. Competition in the market will become competition before this committee or in the halls of the Fed, lobbyist-to-lobbyist and lawyer-to-lawyer.

The government resolution authority in the Draft is based on the faulty assumption that anyone can know, in advance, whether a particular company will—if it fails—cause a systemic breakdown. In reality, this is unknowable, but the Draft authorizes government officials to make this determination—this guess—without any standards for doing so. In other words, the Draft gives government officials unfettered discretion to take over companies they believe will cause a systemic breakdown.

Officials who have this authority will almost certainly follow a “better safe than sorry” policy—taking over companies that would only create economic disruptions of some kind, rather than a full-scale systemic breakdown. General Motors and Chrysler are examples of this. They were not systemically important, but they were politically important. Their failure would not have caused a systemic breakdown, but would have caused a loss of jobs and other economic disruption. Politically powerful companies like these will be rescued while those that are not will be sent to bankruptcy. The markets will have to guess which will be saved and which will not.

Worse than giving government officials this enormous discretionary authority is what the Draft authorizes them to do with it.

They can rescue some companies and liquidate others; they can pay off some creditors and not others; and using government funds, they can keep failing companies operating for years—and competing with healthy companies. This will not only create uncertainty and moral hazard, but it will give the large and powerful companies special advantages over small ones. Those that seem likely to be taken over by the government will have easier access to credit, at lower rates, than those likely to be sent to bankruptcy.

In other words, the Draft proposes nothing more or less than a permanent TARP, using government money to bail out the large or politically favored companies, and then taxes the remaining healthy companies to reimburse the government for its costs of competing with them.

Full Statement

The October 27 Discussion Draft is a very troubling proposal. In the name of preventing another financial crisis and “protecting” the taxpayers against more unnecessary government spending, it would take control of the financial industry in the United States, stifle risk-taking and initiative, and change competitive conditions in every sector of the economy so that they favor large, government-backed, too big to fail enterprises.

In this written statement, I will discuss only the sections of the Draft that deal with systemic risk, prudential regulation, and a resolution authority.

The Draft would create a Financial Services Oversight Council. It would have limited authority to monitor developments in the market that might threaten the stability of the financial system, and the power to designate financial companies and activities that should be subject to heightened prudential standards.

The heightened prudential standards would be applied principally by the Federal Reserve Board. The Board gets this authority in the Draft through a revision of the Bank Holding Company Act. Under that act, the Fed has regulatory power over all companies that control banks. The purpose of this authority was to assure the separation of banking and commerce. In the Gramm-Leach-Bliley Act of 1999 bank holding companies were permitted to control financial activities such as securities dealers and insurance underwriters. In order to permit this, the act was modified so that in effect it separated finance and commerce, not just banking and commerce. Companies that controlled nonbank financial institutions such as securities forms were then called financial holding companies. The purpose and policy behind of the act, however, was still to assure that the risks taken by the holding company and its subsidiaries did not jeopardize the financial condition of the bank and that the nonbank affiliates of the bank did not gain any access to the bank safety net—insured deposits and the discount window.

The Draft moves completely away from this purpose, and would now give the Fed authority to regulate any financial company that the Council determines should be subject to "heightened prudential standards," even if there is no insured bank in the group. This designation would be based on the Council's belief that the failure of such a company would cause instability in the U.S. financial system—in other words, a systemic breakdown of some kind.

Separating finance and commerce

Any company subjected to heightened prudential regulation (which I will call a Designated Company) that is *solely* engaged in financial activities will be regulated by the Fed as though it is a financial holding company under the Bank Holding Company Act. Designated Companies that are engaged in non-financial activities are required by the Draft to split off their financial activities into a separate holding company, which will then be regulated by the Fed.

One of the most serious problems with this approach is that there is no way to define a difference between a financial and a nonfinancial activity. The result is that the question becomes one of political clout, with industries fighting in Congress for the competitive result they want. Some industries want to invade others' turf; the invaded industry uses the law to fend off the competition; consumers are the losers. Congress becomes the battleground. It's not just unseemly; it's a frightening example of what happens when the government starts picking winners. There is already a clear example of this. Shortly after the GLBA was passed, the banking industry asked the Fed to declare real estate brokerage to be an activity that is "financial in nature." This would have enabled financial holding companies to compete with real estate brokers. The brokers of course went to Congress and got a warning to the Fed not to declare real estate brokerage a financial activity. The Realtors had won.

This bizarre event makes two points about the Draft. First, and most important, it shows that there is no principled way to decide what is a financial activity and what is not. How can securities brokerage be a financial activity, but real estate brokerage is not? The second is that Congress will be injecting itself into competitive fights between firms and industries, further politicizing what should be economic or financial decisions. Questions like the real estate brokerage issue will come up endlessly if the Draft is ever enacted into law, with industries fighting one another in Congress and at the Fed about whether a particular activity is financial or not. Some will try to use it as a shield to protect themselves against competition; others will try to use it as a sword to damage competitors.

In addition, the idea that a company will have to separate its financial activities—whatever they turn out to be—from its normal operations is bizarre, and reflects the triumph of government convenience (and perhaps a complete ignorance of the nature of commercial activity) over common sense. Companies of all kinds, from manufacturers to retailers, finance their sales. The Draft suggests that Designated Companies must now separate their financing activities and place them in a separate company. The costs of this will be substantial.

Then, incredibly, the separate holding companies that the Draft requires will not be able to finance their own affiliates without complying with the restrictions in Sections 23A and 23B of the Federal Reserve Act, which requires that such financing be limited in size and subject to collateralization. Under 23A and 23B, a loan to a third party that assists an affiliate's business is considered a loan to the affiliate, so that the financing arms of Designated Companies will not be able to finance their affiliates' sales. So, for example, GE Capital would not be able to finance GE's sales of aircraft engines. Did anyone who drafted this legislation consider how U.S. companies are supposed to compete with foreign companies?

Prudential regulation, too big to fail, and the Fannie/Freddie problem

Apart from its bizarre effort to separate finance and commerce—so financial companies can be more easily regulated and controlled—the Draft imposes costly and intrusive new regulations on Designated Companies that have never been required of bank holding companies in the past. Thus, in the Draft the Fed's prudential regulatory authority includes the usual items—such as risk-based capital requirements, leverage limits, and liquidity requirements—but would also include overall risk management requirements and "any other prudential standards that the Board deems advisable." These could include requiring a company subject to the requirements to "sell or otherwise transfer assets of off-balance sheet items to unaffiliated firms, to terminate one or more activities, or to impose conditions on the manner in which the identified financial holding company conducts one or more activities."

In other words, the Designated Companies are under the complete control of the Fed. They will not be able to initiate new activities without the Fed's approval, or enter new competitive fields, or perhaps even open new offices in new places. This is a degree of political control of business that has never been attempted before. Not only will it place the dead hand of government on the activities of financial companies, but it will almost certainly drive many financial companies out of the United States before they submit to these restrictions.

The effect of these restrictions for the U.S. economy will be dire. First, Designated Companies will clearly have been labeled as too big to fail. In effect, the government has notified the capital markets that these firms will not be allowed to go into bankruptcy—they will be rescued in the ways I will describe below. This means they will be less risky borrowers than smaller companies that are not going to be controlled in the same way. As less risky borrowers, the Designated Companies will have lower costs of funding and will be able to drive smaller competitors from the markets they enter. Sound familiar? Yes, it's Fannie Mae and Freddie Mac all over again. The existence of these Designated Companies will impair competition in every market they are allowed to enter, and will force the consolidation of competitors so that markets become dominated by government-backed giants like themselves.

In addition, while driving out smaller competitors, these large companies will not be permitted to innovate because this would create unacceptable risks for the Fed or any other regulator that has control of their activities. The U.S. financial markets will stagnate, consumers and businesses will have to pay more for their credit, and competition—except among those lumbering and government-backed giants—will be stifled.

The rationale for the foregoing restrictions is that they are designed to prevent a systemic breakdown—or, as the Draft describes it, “instability in the U.S. financial system.” But one must ask whether it is possible to determine, in advance, whether a particular company will cause a systemic breakdown. It’s important to understand what is going on here. Government officials, who would have no idea whether a company on the brink of failure would in fact cause a systemic breakdown if it failed, are going to have the power to declare that certain companies—because of attributes these government officials believe are significant —could, at some time in the future, under circumstances no one can know, cause instability in the financial system if they fail. And this possibility is so likely to occur that our entire financial system must be subjected, today, to far-reaching control by the Federal Reserve Board. With all due respect, this is absurd, and certainly disastrous for economic growth in the future.

The Draft also contains language that suggest some of the problems of identifying Designated Companies in advance—and thus creating the Fannie/Freddie too big to fail problem—can be avoided if the designation of these companies is not disclosed to the public. This, too, with all due respect, is absurd. Securities disclosure alone will require these companies to reveal their special status, and it will be in their interests to do so because of the advantages it will give them.

Finally, it is necessary to question the whole notion that any regulatory agency can regulate banks, bank holding companies, insurance companies, hedge funds, finance companies and any other kind of company that might be selected as a Designated Company. Not only would this require an extraordinary range of expertise in the staff of the Fed—detailed knowledge of how companies in each of these industries operate—but also a knowledge of how decisions with respect to one kind of company will affect the others. The Draft seems blissfully unaware that all these companies and industries compete with one another. A change in the capital requirements of, say, hedge funds, will affect how they compete with bank holding companies or securities firms, or finance companies. In other words, the Fed would have to take into account in deciding such thing as capital requirements what adjustments it would be required to make for all the companies in all the industries involved, so that it is not giving any one industry an advantage. Once again, if the Draft proposals are ultimately adopted, all these issues will be fought out in Washington—lobbyist-to-lobbyist and lawyer-to-lawyer—as the industries fight to get the political organs of government to help them and hurt their competitors.

Resolution authority

The question whether it is possible to know whether a particular company’s failure will cause a systemic breakdown or instability also becomes relevant when reviewing the Draft’s provisions for a resolution authority. Those who developed the Draft should be asked how anyone can possibly know whether a particular company—when on the brink of failure—will cause a systemic breakdown if it fails. As in the case of firms selected as Designated Companies, The honest answer, if it ever comes, is that there is no way to know this, and the fact has great significance for what the resolution authority outlined in the Draft authorizes a government agency to do.

That authority would go mostly to the FDIC, but the decision to take over a particular company is a corporate one under the Draft, involving the company's regulator as well as the Secretary of the Treasury (who must consult with the President). Is it reasonable to believe that the decision will ever be no? This is highly unlikely. Since no one knows what will happen if a large financial company fails—clearly Hank Paulson and Ben Bernanke did not anticipate what would happen after Lehman failed—the tendency of all regulators and other officials will be to rescue any Designated Company. That is true because, by hypothesis, Designated Companies are so designated because their failure is likely to cause instability or a systemic breakdown. If such a company's failure doesn't have that result, it calls into question the necessity for the entire regulatory structure outlined in the Draft. On the other hand, if the failure of a Designated Company results in some serious disruption, the regulators and the administration will be blamed. After all, why were they given the power to take over failing companies if they were not going to use it when necessary? So if there is actually a debate about the subject, all of the weightiest arguments will favor rescuing one of these Designated Companies if it looks likely to fail.

In addition, there is very little incentive for the government *not* to rescue failing Designated Companies, because the Draft provides that the surviving members of the financial industry larger than $10 billion in assets—whether Designated Companies or not—will be taxed to reimburse the government for its costs in the bailout.

What would such a rescue look like? The Draft is quite specific that the FDIC of any other agency handling a resolution will have tremendous discretion. Companies that are rescued can be saved from failure and resuscitated as going concerns, or they can be liquidated or broken up. Although the Draft says that management will be replaced and the shareholders wiped out, the significant question is whether the creditors will take losses. Here the Draft becomes highly unspecific. Yes, the unsecured creditors will take losses, but which creditors and when is not specified. Unlike a bankruptcy—where the losses of creditors are determined by the orderly way in which a bankruptcy court works through creditors' priorities—in the resolutions contemplated by the Draft politics will play a large part. As in the GM and Chrysler bailouts, preferences are going to go to favored groups, and disfavored groups will suffer disproportionate losses. It will be a political free for all, with important legislators pressing the FDIC to treat their constituents better than someone else's constituents.

What we know is that no losses will be taken immediately by creditors. This is because the objective of the resolution authority is to prevent a "disorderly" failure, which actually means a failure in which creditors suffer immediate losses. That's what happens in bankruptcy, and if immediate losses to creditors are what is contemplated in the Draft, there would be no point having a resolution authority. The Draft provides that the company taken over will be operated for as long as two years, with possible extensions for up to three years, while the "orderly" liquidation or the return to financial solvency is gradually worked out. It's important to recognize what is really happening here. A company that—despite (or perhaps because of) heavy regulation—has failed is then to be supported by government infusions of cash so it can continue operating and competing with the healthy companies that did not fail. Then, after this competition weakens the companies that have not failed, the failed company is either returned to the market in healthy condition or liquidated. In either case the healthy companies that survived will then have to pay for the government's costs in keeping their competitor in operation. It's hard to see the logic of this, let alone the equity.

There are several other issues associated with the resolution authority, all of them important. The first is the creation of competitive inequity, especially for smaller companies. As noted above, designating certain companies as too big to fail creates the Fannie/Freddie problem. But even if the Draft did not create competitive inequity in this way, it would surely be created through the operation of the resolution authority. By rescuing failing companies and returning them to health, or by taking them over and liquidating them over time—both of which are contemplated in the Draft—creditors have in effect been told that if they lend to one of the companies likely to be taken over they will have less risk of loss than if they lend to the smaller companies that are not eligible for takeover (the Draft actually does not limit the potential takeover targets to Designated Companies). Indeed, if there were no Designated Companies, the market would be left to guess which companies will be likely to be taken over and which will not, and smaller companies would not be in the running.

It also introduces again the specter of politicization. Lobbyists and experts will be well paid to get the outcome from the government that their clients desire. Given the fact that they will eventually have to pay for the takeover, the financial industry will probably try to get the failing company sent to bankruptcy, but the company itself, its creditors, employees, suppliers and patrons in the political process will be fighting on the other side. Again, this is the spectacle that the legislation in the Draft will provoke, another confirmation that Washington and the political system—rather than competition and effective financial performance—will have become central to what happens in the financial industry.

As takeovers of companies continue, the Lehman problem will develop. That is the belief in the market that failing companies will be taken over because others before them have been taken over. The Lehman problem arose from the Bear Stearns rescue; after Bear Stearns, market participants believed that all larger companies would be rescued. When that didn't happen with Lehman, there was a market breakdown as all major participants realized that they had to look at the financial condition of counterparties that they had assumed, before Lehman, would be rescued by governments. The pernicious element of the Lehman problem is that it feed on itself. Once the market comes to expect that takeovers will occur, they will have to occur, or nasty surprises will cause severe market disruptions.

There are also questions about the competence of the FDIC. No one questions the ability of the FDIC to resolve small banks. They do it steadily and without apparent incident (although, despite prompt corrective action, they have been losing about 25 percent on average in the assets of the banks they close). But does the FDIC know anything at all about how to resolve a hedge fund, or an insurance company, or finance company—especially a large and complex one that is the archetype of the Designated Company? The answer to this question is no. They have no more knowledge about how to close down a large nonbank financial institution than the any other agency of government. The expertise exists nowhere in the government, yet the Draft blithely hands this important authority to the FDIC as though its work with small banks is a qualification.

In general, in the two areas covered in this statement, the proposals in the Draft reflect very bad policy—far more likely to be destructive of the financial system and damaging to the economy than an improvement on what exists today.